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Behind the German and Swiss Monetary Tightening

The recent rises in German and Swiss discount and Lombard rates were motivated by foreign-exchange considerations rather than domestic conditions. They were clearly meant to bolster the German mark and Swiss franc against a dollar much strengthened by higher U.S. interest rates.

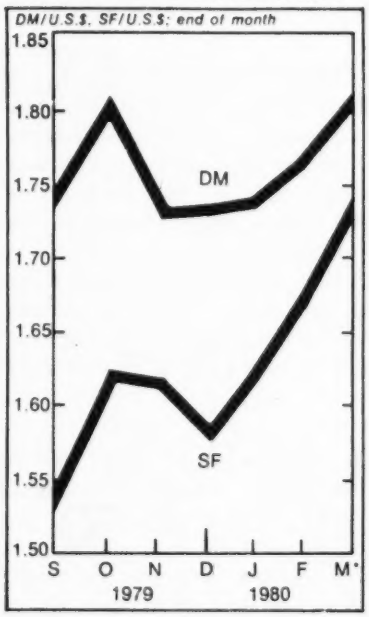
Monetary growth in Germany is continuing well within its target range, and money market rates were already 300 basis points above the inflation rate prior to the latest rate hikes. Moreover, initial wage settlements of about 7% were moderate, and an economic slowdown is widely forecast for the second half of 1980. There was, therefore, no apparent domestic incentive for further German monetary tightening. This fact was acknowledged by the Bundesbank in its decision to raise commercial bank rediscount quotas by DM 3 billion and abolish the Lombard quota at the same time that it boosted rates.

In the open European economies, both the local currency oil-import bill and the price level are strongly affected by the exchange rate. In Germany, every 1% decline in the mark against the dollar raises the oil-import bill by about DM 600 million. While the inflationary impact is harder to quantify, a 1% decline in the mark could ultimately raise the German price level by as much as 0.5%. A substantial weakening of the mark could therefore trigger an uncomfortable surge in German inflation. The result would be either an erosion in real wage gains—which would spur higher wage demands in the longer run—or higher wage settlements from the current negotiations still proceeding.

Over the past two years, the German and Swiss authorities were able to avoid this dilemma. They did so partly by influencing exchange-rate expectations by means other than interest-rate policy. Now, however, the weakened German and Swiss external accounts, the limited markets for OPEC's surplus funds, and the favorable cost-competitive position of U.S. exports are all forcing an increased reliance on interest-rate differentials as a means of affecting exchange rates.

If the United States moves decisively to tighten monetary policy, Europe's hard-currency countries will have little choice but to accept more-restrictive monetary policies themselves. But if the markets are disappointed by U.S. measures, Germany and Switzerland may once again enjoy exchange-rate strength without having to raise their interest rates further.

The exchange values of the mark and Swiss franc



*as of March 11

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Foreign trade a source of Canadian economic strength.

Canadian foreign trade is holding up well despite the threat of a U.S. recession. The trade balance posted a surplus of C$4 billion last year, well above the C$3.4-billion surplus of 1978. Although the monthly trade surplus declined in January 1980, it was still running at an annual rate of about C$3.5 billion. The export sectors showing the greatest strength were oil and gas, chemicals, trucks, non-ferrous metals, and agricultural machinery. And sales have been brisk not only to the United States—which absorbs 70% of Canadian exports—but to Europe and Japan as well. The strong trade performance has boosted the value of the Canadian dollar and helped raise international reserves (less gold) from $2.8 billion in December to $3.5 billion in February. If export earnings maintain their present pace, Canada will be able to offset rising service payments and keep its current-account deficit from widening much beyond the C$5.3 billion estimated for 1979.

New Irish budget strives for austerity.

The new Irish budget, unveiled on February 27, marks a major shift in economic policy. Since 1977, the Government has sought to sustain rapid growth through highly expansionary fiscal and monetary policy. The policy worked well for a while, giving Ireland one of the fastest growth rates in Europe. But problems emerged in the form of an expanding budget deficit, a widening current-account gap, and accelerating inflation. The new budget is aimed at alleviating these imbalances, at the expense of economic growth. Public expenditures will be curbed so as to reduce official borrowing needs from about 14% of GNP to 10%. At the same time, the Government will increase its share of revenues from sales taxes relative to income taxes in response to taxpayer complaints. These initiatives are expected to help trim economic growth to about 2% this year, compared with 3.5% in 1979 and 5.9% in 1978. This reduced growth should in turn prevent a widening of the $1.6-billion balance-of-payments deficit posted last year. A problem is the extent to which the higher sales taxes trigger higher wage grants, since the high inflation rate—expected to run at 17% in 1980—could persist and compromise Ireland's membership in the European Monetary System.

Belgium's tight money policy aims to bolster the franc's exchange value.

In line with higher interest rates in Germany, Switzerland, and the United States, Belgium recently raised its central bank discount rate from 10.5% to 12%. With the year-on-year inflation rate at 6% in January, the discount rate is now six percentage points above the inflation rate, an unusually large differential. This degree of monetary tightness was necessitated by the weakness of the Belgian franc within the European Monetary System, which in turn was largely the result of the combined current-account deficit of Belgium and Luxembourg. This deficit rose to an estimated $3.3 billion in 1979 from $900 million in 1978. With the expectation of reduced export growth in 1980 and oil prices averaging 60% higher than in 1979, the 1980 current-account deficit may climb as high as $4 billion, forcing the continuation of high interest rates to protect the franc in the EMS.

Danish policy stringency limited by political considerations.

Denmark's persistent balance-of-payments deficit widened to kr. 15.6 billion in 1979 from kr. 8.2 billion in 1978. Simultaneously, the country's annualized inflation rate rose from 6.7% at the start of 1979 to 11.9% at year-end. The authorities have responded with successive devaluations of the kroner and increases in interest rates to sustain capital inflows and dampen domestic demand. The kroner was devalued by about 3% in September and by another 5% in November 1979, while the central bank discount rate was raised from 9% to 11% in September 1979 and to a record 13% in February 1980. Attempts to introduce a stringent incomes policy, however, have been thwarted by the need to preserve the fragile coalition government formed after the general election of October 23. In the absence of tougher measures that might turn the economy around, the 1980 current-account deficit will likely approximate the 1979 shortfall, while inflation

will average some 10.5%. Thus, Denmark will be forced to continue living on borrowed time, supporting its very high standard of living—per capita income is about 11.5% higher than in the United States—by borrowing more abroad and increasing a foreign debt burden that is already equivalent to 20% of GNP.

Pakistani current-account deterioration will require more foreign borrowing.

Pakistan's current-account balance is on a steady downtrend in the current fiscal year (ending in June). Although export growth was about 50% in the first half of the fiscal year, earnings in the second half will be hurt by the slowdown in world trade. Total export receipts will nonetheless reach approximately $2.2 billion, topping the official target of $1.9 billion. While imports are weakening as a result of stepped-up controls and higher import taxes, they are expected to increase by some 12% because of soaring oil prices. The trade deficit is thus likely to remain in the area of $2.1 billion, roughly the same as last year. But in view of the decline in worker remittances from abroad and higher interest payments on debt, the surplus in the invisibles account is expected to narrow to about $700 million from $1 billion last fiscal year. The current account will therefore be about $1.4 billion in the red, compared with a $1-billion deficit last year. And financing the deficit will further enlarge Pakistan's already heavy debt burden.

New Thai leadership faced with task of selling energy price hikes.

Thailand's new prime minister is not expected to alter the course of government policy in any major way. But he must now address the economic issues that led to his predecessor's departure. The most critical of these is the need to win public approval of large price increases for oil products, electricity, and other energy-related goods necessitated by the sharp rise in imported oil costs. The sharpest increases apply to diesel fuel, kerosene, and cooking gas, all politically sensitive items that were underpriced for years. Rescinding or modifying these increases would calm public protest but saddle the Government with heavy subsidies. The new prime minister will need to appoint a chief economic minister strong enough to win public endorsement on this and other difficult issues.

Peruvian economy strengthens.

Peru's economy experienced a remarkable turnaround in 1979. The combination of restrictive demand-management policies, corrective price and exchange-rate adjustments, unexpected terms-of-trade improvements, and successful export promotion efforts have enhanced the country's fiscal and external position and have reversed the deterioration in economic activity. The central government deficit shrank from 5% of GDP in 1978 to 1.6% last year, while the current account of the balance of payments shifted from a deficit of $190 million in 1978 to a surplus of $590 million. The improvement in the external sector allowed the authorities to obtain a waiver on the debt rescheduling negotiated in late 1978, and to prepay 1979 maturities. As for economic growth, real GDP is estimated to have advanced about 2.8% following two years of decline, with most of the gains concentrated in the export-oriented sectors. Nevertheless, two major problems remain unresolved: an inflation rate that continues in the 70% range and widespread unemployment.

U.S. and Soviet purchases will keep wheat prices firm.

Wheat prices initially fell following the January 4 announcement by the United States that grain sales to the Soviet Union would be curtailed. Earlier this month, when the Department of Agriculture announced it would begin to implement its program to buy 4.5 million tons of wheat denied the Russians, prices rose sharply but still remained below their extremely high pre-embargo level. Since then, they have come down again in response to good weather conditions for the winter 1980 crop and soaring interest rates, a depressing influence on most commodities at this time. Wheat prices are expected to fluctuate around current levels over the next few months and eventually move higher, as U.S. Government purchases are sustained and as the Soviet Union continues to increase its grain imports from other countries.

New Pressure for Deposit Costs

Pressures on deposit costs of banks and thrift institutions are likely to intensify in coming weeks. An important contributing factor will be the higher interest rates applying to renewals of maturing 6-month money market certificates (MMCs) issued by banks and thrifts. Indeed, in view of present earnings problems at certain institutions, there has been increasing discussion of the possibility that regulatory agencies may impose new constraints on the rates of interest that may be offered on MMCs.

Money market certificates were first introduced in mid-1978. The maximum rate presently authorized for MMCs is the average new-issue rate on six-month U.S. Treasury bills. Over the past year-and-a-half the growth of these instruments has far exceeded expectations—as, of course, has the rise of interest rates generally. At the end of January 1980 outstanding certificates amounted to $290 billion, of which around $137 billion, or 47%, was at savings and loan associations (S&Ls) and $116 billion, or 40%, was at commercial banks. MMCs have accounted for a steadily rising share of the funding of many institutions—for example, they are almost 30% of total savings at S&Ls and over 25% at savings banks.

The new pressures on the earnings of many institutions will be especially troublesome during April, when an unusually large amount of MMCs will mature. These represent certificates written in October 1979. That month's net increase in MMCs approximated $31½ billion, one of the largest increases in a single month since these instruments were introduced. Last October rates on new six-month Treasury bills averaged "only" 11.34%; the rate is currently around 15%.

Regulators face a dilemma. It will be difficult to insulate hard-pressed institutions from the full effects of current interest rate levels without encouraging depositors to invest their funds elsewhere. There has been some effort of late to provide a partial resolution. Last December, agencies authorized a new long-term consumer CD having a maturity of 2½ years or more and a maximum yield tied to that of Treasury securities. This new certificate was apparently quite popular with consumers. But late in February regulators imposed a new absolute ceiling of 11¾% for banks and 12% for savings banks and S&Ls. (On the previous basis, the 2½ year ceiling for banks in March would have been about 13¾%.) Regulators justified the ceiling change by the assertion that market rates on such instruments were not warranted, in view of current rates of return on those long-term assets in which such funds would be invested. A similar kind of rate cap mechanism may be ahead for the MMCs. Such a move by regulators, however, could add new liquidity problems to the profitability pressures already facing many institutions.

Africa and Middle East Bimonthly Survey of Business and Finance

	COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP in 1978		BALANCE				
			3 months ending	Change from year earlier	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	use cre lions
Africa	Algeria	Plan for 1980-84 will give higher priority to agriculture and social development.	Dec.	+ 49%	19.3*	$ 1,075	Jan.	2,726	+ 54%	4.9	
	Angola	New foreign investment law permits foreign private investment via joint ventures with Government.	Dec. '78	+ 6%	2.6	407	Dec. '78	295	n.a.	4.0	
	Burundi	New investment code being prepared, with aim of attracting foreign capital for development.	Sept.	+127%	0.6	140	Dec.	90	+ 11%	1.0	
	Egypt	Agreement reportedly reached with IMF on new 3-year credit for $650-$700 million.	Sept.	+128%	18.8*	484	Nov.	367	— 12%	1.5	
	Gabon	Concentration on productive development projects should return economy to growth path.	Dec.	+ 24%	3.6**	3,800	Sept.	11	+ 49%	1.0	
	Ghana	Budget of $1.3 billion for 1979/80 is 19% above 1978/79.	n.a.	n.a.	14.3*	130	Oct.	283	+ 14%	n.a.	
	Kenya	Heavy defense spending implies substantial foreign borrowing.	Aug.	+ 32%	5.5	370	Dec.	625	+ 77%	4.7	
	Madagascar	Development plan for 1978-84 emphasizes light industry.	Mar. '79	— 14%	2.0	240	Aug.	63	— 30%	1.8	
	Morocco	Government austerity measures restraining economic activity.	June	+ 19%	12.8	678	Dec.	557	— 10%	2.1	
	Nigeria	Agricultural production seen expanding at 2% pace for second consecutive year.	Nov.	+ 69%	41.4	520	Dec.	5,548	+194%	4.3	
	South Africa	Invulnerability to oil price rises boosts business and consumer confidence.	Oct.	+ 36%	45.7	1,650	Jan.	654	+ 37%	0.6	
	Tunisia	France provides $108 million in loans for industrial and other development.	Sept.	+ 84%	5.8	936	Jan.	543	+ 20%	2.4	
	Zaire	GDP stagnated in 1979, following four years of decline.	Mar. '79	+ 28%	5.4	230	Nov.	294	+ 73%	6.0	
Middle East	Iran	Work to resume with Japan on large Bandar e Khomeini petrochemical project.	Dec.	+ 55%	76.4*	2,227	Nov.	14,715	+ 28%	n.a.	
	Jordan	Higher oil import costs prompt increase in domestic prices of petroleum products.	Dec. '78	+ 34%	2.3	587	Jan.	1,118	+ 23%	9.0	
	Kuwait	Domestic exploration for oil to be stepped up.	Dec.	+ 82%	13.9***	12,278	Jan.	2,504†	— 4%	7.0	
	Saudi Arabia	Budget expenditure target for 1979/80 reportedly raised 25% to about $59½ billion.	Dec.	+ 68%	54.5***	8,400	Dec.	19,273†	0	10.5	
	United Arab Emirates	Abu Dhabi development outlay budgeted at $2 billion, up 20% from 1979.	Dec.	+ 88%	13.2*	17,820	Jan.	1,182†	+ 64%	2.6	

*1977 **1979 ***FY 1977/78 †Excluding state rese

Auto Sales Shift Into Low Gear

The U.S. auto industry is bracing for what may prove to be its worst sales year since 1975. Buffeted on the one hand by increased foreign competition and on the other by stiffening consumer resistance, sales of domestically made cars in February fell to nearly 15% below year-ago levels.

As with most durable goods, the demand for autos is strongly influenced by cyclical movements of the economy. In particular, an individual's decision to purchase a new car is highly responsive to changes in real disposable income. Over the past six months alone, consumers have seen their real incomes decline by almost 1%. Economists fear that further deterioration is likely. In addition, consumers' ability to supplement their real incomes by cheap and easy borrowing and by drawing down savings may at last be tapering off. Personal saving is at an historically low level and record high interest rates in recent weeks have dramatically dampened the growth of consumer debt, which is especially important to new auto sales. Finally, the prevailing uncertainty over future economic conditions may be prompting consumers to delay purchasing new autos.

The economic uncertainty at home is compounded by the political uncertainty in the Middle East. With continued anxiety over gasoline prices and availability, American car buyers have demonstrated a growing preference for smaller, more fuel-efficient models. As a result, domestic auto makers have been increasingly hard hit by foreign competition. Import sales were up again in February as overseas manufacturers captured more than 27% of the U.S. new car market—a record share for the second month in a row.

One unfortunate byproduct of dramatic Japanese gains in the U.S. market has been a resurgence of protectionist saber rattling in Congress. Advocates of trade restrictions to protect the domestic auto market point to U.S. car makers' drastic production cutbacks and layoffs of some 200,000 American auto workers. Some U.S. lawmakers have warned that new protectionist legislation is imminent unless Japanese auto manufacturers either curtail their car sales to the United States (which in 1979 accounted for 40% of Japanese auto exports) or follow the example of another foreign car maker and set up plants in America. But with the exception of one auto producer, Japanese car manufacturers thus far seem inclined to take their chances that the United States will not impose drastic restrictions on auto imports—primarily, they say, because they do not expect their present competitive advantage to last.

U.S. manufacturers themselves have high hopes that sluggish sales will greatly improve in September when they introduce new models designed to meet the foreign competition head-on. Even then, much will depend on the state of the economy and consumer confidence. But at least over the next several months, there is little prospect of any sales turnaround.

OF PAYMENTS		MONEY AND BANKING							COUNTRIES
f IMF, mil-dollars	current influences on payments	12-month changes: latest data	consumer prices	latest data	domestic credit	central bank rate (March 12, 1980)	exchange rate in U.S. dollars (March 12, 1980)	current monetary conditions	
)	Sharp increase in LNG export prices sought.	Dec. '78	+ 17%	July	+ 30%	—	.2725	Banque Nationale raises $200 million Euroloan.	Algeria
.	Oil earnings could reach $2 billion in 1980.	n.a.	n.a.	n.a.	n.a.	—	.04	Brazil grants $30-million export credit.	Angola
)	Coffee earnings up sharply in second-half 1979, but imports also jumped.	Dec. '78	+ 31%	Sept.	+ 69%	—	.0113	Credit squeeze in effect.	Burundi
)	Rising world price will raise cotton export revenues.	Sept.	+ 14%	Nov.	+ 59%	9.00%	1.45	Interest payments on official Arab deposits to resume.	Egypt
)	Oil receipts should rise in 1980 as high prices offset 10% output cut.	Nov.	+ 7%	Sept.	− 2%	—	.0048	Credit policy remains restrictive.	Gabon
)	Oil bill was $285 million in 1979, while ban on timber exports hurt receipts.	Dec.	+116%	Sept.	+ 16%	13.50%	.3700	Credit highly restrictive.	Ghana
)	Import deposits relaxed on essentials; selected controls remain.	Nov.	+ 8%	Oct.	+ 11%	—	.1415	Credit restraint continues.	Kenya
)	Rice imports responsible for 75% of trade deficit.	June	+ 12%	Aug.	+ 52%	5.50%	.0049	Central bank coordinates credit expansion.	Madagascar
)	Higher world price will increase phosphate rock revenues this year.	Mar. '79	+ 10%	Sept.	+ 20%	4.50%	.2700	Claims on private sector rising slowly.	Morocco
)	Oil receipts in 1980 should exceed $25 billion.	May	+ 8%	July	+ 14%	5.00%	1.87	International reserves spurt.	Nigeria
)	Anticipated inventory restocking should stimulate increased imports.	Nov.	+ 14%	Oct.	+ 11%	7.00%	1.2425	Money conditions restrictive.	South Africa
)	Sharp rise in imports last year offset by increased oil revenues.	Nov.	+ 10%	Nov.	+ 7%	5.75%	2.55	Money supply rising steadily.	Tunisia
)	Official debt of $1.3 billion rescheduled.	Oct.	+ 93%	Sept.	+ 37%	—	.3450	Credit restraint continues.	Zaire
)	Gas exports to Soviet Union down sharply.	Nov.	+ 9%	June	+ 36%	9.00%	n.a.	Interest payments to be replaced by commissions.	Iran
)	Foreign aid inflow and remittances boost reserves to $1.1 billion in January.	Nov.	+ 13%	Nov.	+ 33%	5.50%	3.40	Central bank raises interest rates payable on deposits.	Jordan
)	Oil output cut of 25% expected in April.	Sept.	+ 5%	Nov.	+ 44%‡	—	3.64	Interest rates on short-term KD loans rising.	Kuwait
)	Oil output averaged 9.25 million bpd last year, up 15% from 1978.	Sept.	+ 2%	Sept.	+ 75%‡	—	.3005	Claims on private sector rising steadily.	Saudi Arabia
)	Dubai output averaged 354,000 bpd in 1979, down 2.3% from 1978.	n.a.	n.a.	Nov.	+ 12%‡	—	.2685	New Central Bank Law to be announced soon.	United Arab Emirates

‡Private sector only

World Interest Rates

market rates of March 12, 1980; bond yields as of March 7, 1980

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	13.00	14.00	17.00	12.00	9.50	7.00	15.00 penalty rate 18.00	9.50	3.00	7.25
Day-to-Day Money	16.50 Mar. 13	10.00	17.00	12.75	13.50	8.80	16.625	10.50	5.125	9.625
Treasury Bills 91-day, Middle Rates	15.60	14.10	16.00	n. a.	14.67 1-year	n. a.	14.85 80-days	no dealing	no market	5.625 2-month
Commercial Paper prime, 3-month, asked	15.00 finance paper	14.50 finance paper 15% tax w/h	15.44	11.90 Certified	14.1875 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	16.90	14.40 15% tax w/h	17.4375	13.75 Certified	not traded	8.40	18.45	no market	4.50 not traded	no market
Government Bonds Long-term, new and old issues, average yield	12.39	13.625	14.48	11.03 20% tax w/h	13.44	9.29	14.54	11.20	4.88	9.10
Industrial Bonds prime, long-term, new and old issues, average yield	13.40 Aa Industrials	14.25	14.79	13.81 20% tax w/h	14.78	9.17	14.74	12.08	5.80	6.97
Bank Short-Term Rate to Best Borrowers (prime rate)	18.25*	15.00	18.50	16.75	14.10	9.75	20.00	14.00	4.50	7.50
Bank Time Deposits 3-month	16.50 Cert. of Dep.	14.40 Cert. of Dep.	17.75	15.50	14.1875	9.35	10.75	12.00 large deposits	6.75 residents only	5.00 20% tax w/h
Eurocurrencies 3-month, asked	18.25	no market	18.625	no market	15.375	6.875	no market	13.00	6.875	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8559	2.2315	.034060	.2365	.5532	.001189	.5033	.5788	.004041
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	4.25 *P*	FLAT	1.375 *P*	4.00 *P*	6.875 *P*	2.75 *D*	6.00 *P*	11.375 *P*	4.725 *P*

Eurodollar Deposits
(London, interbank, bid)
March 13

7-day	16.50
1-month	18.00
3-month	18.5625
6-month	18.4375

International Arbitrage
(3-month, hedged) + *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	− .18
U.S.-Canada Treasury Bills	−2.08
U.S.-Canada Finance Co. Paper	−3.55
Eurodollars-U.K. Local Auth. Deposits	n. a.

Eurobonds
(average yield on recent straight debt issues)

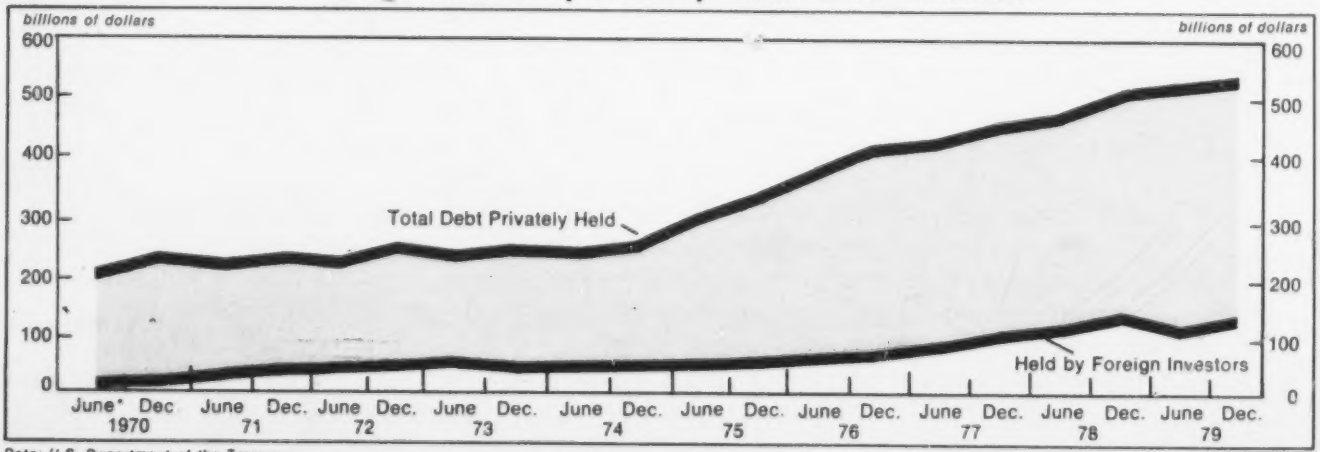
U.S. Dollar Bonds	
7 yrs. and under	14.50
Over 7 yrs.	14.25
DM Bonds	
7 yrs. and under	8.50
Over 7 yrs.	8.75

Gold Price
London afternoon fixing
585.70
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

* Effective Mar. 13.

Foreign ownership of U.S. public debt on the rise



Data: U.S. Department of the Treasury

*End of month

The Changing Nature of U.S. Public Debt

The public debt of the U.S. Government has soared more than 70% in the last five years. As of the end of 1979, the total interest-bearing debt outstanding was $832 billion, an increase of $50 billion in just one year. This debt includes not only borrowing by the Treasury to cover the ordinary budget deficit, which was $28 billion in fiscal 1979, but also funds channeled through various credit programs administered by agencies of the U.S. Government. Interest on the public debt—$60 billion in fiscal 1979—will be more than $70 billion this fiscal year and may exceed $80 billion in fiscal 1981.

Conventional wisdom maintains that the existence of a large debt is not a net burden if it is all held domestically. Under these circumstances, the major effect of public debt is a redistribution of income from the general taxpayer to holders of public debt securities. The largest holders are various official trust accounts, such as the Highway Trust Fund and the Social Security Trust funds. According to the Treasury, these government accounts held about 22% of the total outstanding Federal securities as of November 30, 1979, while another 14% or so was held by the Federal Reserve banks.

The general public held the remaining 64%, or $527 billion. Of this amount, foreign investors, chiefly official institutions, held $121 billion. This large portfolio was acquired quite rapidly by foreign investors in the 1970s. At the end of World War II, foreigners held just 1% of the private debt, and still only 8% as recently as 1970. Although the volume of privately held Treasury debt more than doubled in the last decade, the accumulation by foreign investors skyrocketed six-fold, boosting their share to nearly 23% (see chart on opposite page).

Why the debt piled up

Around 1970, two major structural changes occurred in the U.S. economy. First, to help sustain the rapid economic growth to which the country had become accustomed in the 1950s and 1960s—made possible in part by cheap energy—the Government allowed oil imports to double between 1969 and 1973. The subsequent Arab embargo was thus rendered more effective, and the price of oil quadrupled in 1973-74. The higher energy prices reduced potential output by adversely affecting capital investment and hence, labor productivity. Despite this loss of future wealth, the U.S. dependence on imported oil continued to grow. In 1979, oil prices doubled, once again lowering the growth path of real potential output.

Second, concern about worker safety and the environment led to a spate of new regulatory legislation, mandating capital spending during the 1970s that did not result in measured output. As a result, the growth path of potential output moved still lower.

Policymakers failed to recognize, or chose not to concede, that these changes would prevent the U.S. economy from growing as fast as it did during the 1960s. As a result, two sets of forces were set in motion that served to widen budget deficits. The slower-growing economy generated smaller receipts than expected. And the Government attempted to increase output by cutting taxes and increasing spending. In this situation, the Federal Reserve and government trust funds absorbed their historic share of increases in the public debt. But commercial banks and private citizens did not. Their holdings increased by only 55%, although the total outstanding Federal debt more than doubled.

Foreign official institutions picked up the slack, albeit perhaps unintentionally. With U.S. inflation accelerating in 1977 and 1978, the Fed was somewhat unwilling to let interest rates rise sufficiently to prevent the dollar from depreciating against foreign currencies. In attempts to stabilize exchange rates, foreign official institutions acquired dollars. To earn interest on these assets, they exchanged these dollars for Treasury securities. Indeed, from June 1976 to December 1978, foreign investors acquired nearly $70 billion of Treasury securities. Thus, the effect of fiscal and monetary policies was to attract official capital flows from abroad.

When the dollar strengthened in the first half of 1979, foreign central banks reduced their holdings of U.S. debt at a rapid rate as they sold dollars to limit the depreciation of their currencies. This intervention put some upward pressure on interest rates for U.S. Treasury bills. However, total capital flows may not have been affected. Outflows of official capital were more than offset by inflows of private capital, which accelerated during this period. This divergence of private and official capital flows is almost certainly being repeated in the current episode of dollar strength.

Despite the drawdowns of the past year, foreign holdings of U.S. public debt are still substantial. Billions of dollars of U.S. national income continue to flow abroad to pay the interest. But more importantly, the United States has surrendered a certain degree of control over its monetary affairs to foreign central banks. As long as the existing cooperation is maintained, the U.S. Government will undoubtedly continue to accrue some benefits of lower interest costs, and domestic economic growth will be somewhat greater than it otherwise would be. But at some point, the costs of transferring wealth abroad and of reduced monetary control may eventually come to outweigh the benefits.

Douglas L. Bendt

Israel Pursues a Policy of Austerity

The Israeli economy posted a strong 5.2% real GDP growth rate in 1979, but not without an alarming increase in inflation. Private consumption increased 7% in volume terms as the combination of higher real incomes and easy credit led to heavy purchases of consumer durables. Indeed, house prices rose by about 160%, spurring an 11.5% real increase in investment in construction. Output in other sectors of the economy remained fairly flat over the course of year. Government current expenditures, on the other hand, are estimated to have declined 3.5%, largely a result of reduced defense spending. On the external front, strong growth in import volume combined with higher oil prices to widen the trade deficit to $4.1 billion.

The Israeli authorities are now confronted with several serious problems. The most pressing is inflation. Consumer prices rose at an annual rate of 114% in December. And any reduction in the pace of price increases is complicated by widespread indexation of wages, government spending, and interest rates on government bonds.

A second problem is the continued rapid expansion of domestic credit, fueled by government deficit spending. Bank lending to the public has increased in both local and foreign currency terms. The actual degree of monetary growth is difficult to interpret, however, owing to a widespread flight into foreign currency. This flight accelerated in mid-February amidst uncertainty following the introduction of the new Israeli currency, the shekel. The shekel was introduced as a replacement for the battered pound in an effort to restore faith in local currency; it is valued at ten times the pound.

The third problem is the loss of export competitiveness stemming from the Israeli currency's depreciation by less than the rate warranted by the inflation differential between Israel and its trading partners. The impact on exports in 1979 was to hold the growth in export volume to only 1.6%. Import volume, on the other hand, rose 8%, and sharply higher oil prices aggravated the cost burden—widening the trade deficit from $2.8 billion in 1978 to $4.1 billion last year. Israel's larger deficit is related in part to its return to Egypt of the Sinai oil fields, which had been supplying 20% of its domestic requirements.

The appointment of a new finance minister last November resulted in the unveiling of an ambitious austerity program aimed at alleviating these problems. The package included a partial credit freeze, an increase in import duties, and a reduction in price subsidies and public-sector manpower. Three further actions (or omissions) highlight the resolve of the authorities to give priority to fighting inflation. First, Israelis earning above-average incomes did not receive the full cost-of-living supplement payable in January. The maximum supplement was held to 3,366 Israeli pounds, an amount equal to full indexation only for average-income earners. Second, no adjustments in tax brackets were made to compensate for inflation, thereby bringing about a decline in purchasing power at all income levels. And third, total government spending envisaged in the fiscal 1980 budget was cut nearly 5% in real terms.

The austerity measures are already having effects on the economy. Consumer spending appears to be slowing and credit growth is declining. If the current policy stance is sustained and the budget proposals implemented, economic growth will fall sharply during the rest of the year. In fact, real GDP is unlikely to increase by much more than 2%.

Such a slowdown would have a favorable impact on inflation in the medium term. But in the short run, several factors will work to stimulate further price rises. First is the continued acceleration in labor and other input costs, and second is the reduction of price subsidies on certain commodities. Accordingly, Israeli inflation could average 120% for 1980 as a whole. And in the external sector, the higher oil prices are expected to widen the trade deficit further.

While adherence to a strict austerity program would permit an improvement on both the inflation and external-account fronts, there are several constraints on the pursuit of current restrictive policies:

- Defense accounts for one-third of total government expenditures, while another third is allocated to the repayment of external debt. Therefore, any reduced government spending must inevitably affect industrial and social programs.
- The dampening impact of tight monetary policy on manufacturing, combined with the anticipated further erosion of exports because of reduced competitiveness (owing to an overvalued currency), threatens to boost unemployment beyond 4%. The average annual unemployment rate has not exceeded that level in the last decade, and such a development is thought to be politically unacceptable.

In view of these constraints, it is likely that a new policy initiative will be forthcoming. And it may very well respond to political pressure to reverse course from current free-market principles. A new initiative could take the form of tighter import controls and a temporary freeze on prices and incomes. Also possible is a gradual unwinding of indexation, particularly in the government finance area. In any event, the adjustment of the economy to a more stable equilibrium path over the next couple of years is likely to increase Israel's reliance on external financing.

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